

Date: July 9, 2002

To: Hon. James L. Brulte
Senator, 31st District

From: Elizabeth G. Hill, Legislative Analyst *EH*

Subject: Updated Five-Year General Fund Projections

You have asked us to update our five-year projection of General Fund revenues, expenditures, and the resulting operating balance assuming adoption of AB 425 (as amended June 29, 2002) and related legislation.

Out-Year Projections

When we provided you with our five-year projection in May, we indicated that even if the Governor's May Revision budget proposals were adopted, large operating shortfalls would reemerge in subsequent years' budgets. We estimated that these shortfalls would grow from \$8 billion in 2003-04, to \$10 billion in 2004-05, before declining in subsequent years to \$6.6 billion by 2007-08.

We currently estimate that under AB 425 the annual operating shortfalls would increase by roughly \$2 billion per year relative to the May Revision. As shown in Figure 1, the annual shortfalls would grow from \$9.8 billion in 2003-04 to \$12.3 billion in 2004-05, before declining in subsequent years to \$8.7 billion by 2007-08.

Figure 1

Projected AB 425 Revenues, Expenditures, and Operating Balances^a

(In Billions)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Revenues	\$79.2	\$77.5	\$82.3	\$89.1	\$96.2	\$102.7
Expenditures	76.9	87.2	94.6	100.2	105.8	111.4
Annual operating balance	\$2.3	-\$9.8	-\$12.3	-\$11.2	-\$9.6	-\$8.7

^a Assembly Bill 425 totals for 2002-03. Projections by LAO for all subsequent years.
Detail may not total due to rounding.

Factors Underlying Out-Year Shortfalls

Factors Common to Both the May Revision and AB 425. The large operating shortfalls that occur under both the May Revision and AB 425 reflect the large amount of one-time or limited-term solutions used to cover the budget shortfall in 2002-03. Examples include the securitization of tobacco settlement receipts (one-year benefit), loans from transportation funds (one-year benefit), the one-year increase in the vehicle license

fee, the two-year suspension of the net operating loss deduction for businesses, and the two-year deferral of debt-service payments related to the Treasurer's debt restructuring plan. The drop off of savings from these limited-term solutions, coupled with added spending for transportation required by Proposition 42, results in a widening gap between underlying expenditures and revenues through 2004-05. While we expect underlying revenue growth to eventually outpace underlying expenditure increases, large annual budget shortfalls persist through the end of the forecast period, absent corrective actions.

Additional Factors Under AB 425. The roughly \$2 billion in additional shortfalls that occurs under AB 425 largely reflects the restoration by the Legislature of ongoing spending reductions proposed by the Governor in the areas of health, social services, and local government. These restorations were offset in 2002-03 primarily through one-time increases in the amount of loans, transfers, and deferrals.

Treatment of Loan Repayments. Our out-year estimates take into account repayments for the \$1.2 billion in transportation loans as well \$100 million in other loans for which specific payment dates were added by the Legislature. They do not include the potential impacts of approximately \$600 million in other loans for which no specific repayments dates were established. These other loans could further add to out-year pressures both under the May Revision and under AB 425. (In addition, the repayment date for a \$218 million loan from the Beverage Container Recycling Fund was set for 2009—after the end of the five-year forecast horizon.)

Should you have any questions about these estimates, please feel free to contact Brad Williams of my staff at 319-8306.